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Blaine Turnacliff - Jade & Fountain PRC Lawyers

How to protect licensors where their Chinese licensee faces financial difficulties?

Introduction

The area of bankruptcy presents special challenges in the PRC. Closing companies may not be new in China but formally going through bankruptcy proceedings is very new. In 2008, approximately 300,000 companies closed but only a handful went through formal bankruptcy or insolvency process.

From a legal point of view, bankruptcy is a new area of law with a brand new law passed in 2007. However, other than the passage of the new law, the government has provided very little guidance how the courts or legal profession should handle the details. For example, detailed regulations usually follow the issuance of major laws, but until now no such regulations have been issued for the new bankruptcy law. The courts and the judges have almost no experience how to preside over cases and very few business owners or lawyers are familiar with the procedure. Consequently, to date hardly any bankruptcy cases have been heard and dealt with by Chinese courts.

This illustrates the current problem with legislation in the PRC. In the last few years, heaps of new laws have been passed that would allow China to operate and manage its major market economy and modernization of society, many issued under controversy and without a full consensus of lawmakers. Often as is in the case of bankruptcy, these are first ever laws in new fields of law never before covered in China. It is imperative to have further clarification in form of implementing regulations and guidance and training to the courts, judges and lawyers to allow for proper implementation. But for lack of resources and lack of consensus how to deal with the unresolved questions by the lawmakers, no guidance is forthcoming. It will likely be some time before we can expect greater clarification.

The bottom line is the bankruptcy procedures are untried, untested and not understood by the courts, judges, lawyers and businesspersons in PRC.

Highlights of the *Enterprise Bankruptcy Law of the PRC* (June 2007)

1. First bankruptcy law in China, replaced a trial bankruptcy law that only applied to state owned companies.

2. New law applies to all company forms including private, public, foreign invested and state owned companies.
3. Does not apply to individuals – the PRC does not have personal bankruptcy system for individuals.
4. Allows for bankruptcy, reorganization (similar to US Chapter 11), and settlement with creditors.
5. A creditor or the debtor may apply to the courts to initiate bankruptcy proceedings.
6. Courts have a great deal of discretion in deciding whether or not to accept a case (for example, will the courts accept a bankruptcy application initiated by creditors against a state owned enterprise?)
7. Creditors not given a voice in choosing the bankruptcy administrator, the courts decide, although administrator subject to supervision of the creditor.
8. Bankruptcy proceedings and orders are binding on debtor's worldwide assets. Similarly, orders granted outside of PRC are binding on assets inside of PRC. Chinese Peoples Courts may also recognize, confirm and enforce foreign bankruptcy court judgments and rulings within the PRC. However, effect may be limited as it depends on presence of reciprocal bilateral treaties that PRC has entered into and China has not signed any such agreements. So confirmation and enforcement would be done on case by case basis. And courts will have some discretion when confirming foreign judgments under banner that foreign judgment cannot violate basic principles of PRC laws, damage sovereignty, public interests, and legitimate rights of creditors in PRC.
9. Continuation of ongoing agreements - After court accepts an application for bankruptcy, the bankruptcy administrator has the right, subject to approval of the court, to decide to continue or rescind ongoing agreements. If bankruptcy administrator decides to continue an ongoing licensing agreement, then licensor must continue to perform, but licensor has right to request bankruptcy administrator to provide a guarantee, and if does not the agreement is rescinded. However, if bankruptcy administrator does not inform other party within two months from day of court acceptance of the bankruptcy, then licensing agreement deemed to be rescinded.

Bankruptcy courts in PRC

PRC does not have specialty bankruptcy courts and only very few judges have received any bankruptcy training. The ones who have received such training are generally located in the major cities such as Shanghai or Beijing. PRC Bankruptcy Law states the People's Court where the debtor is located has jurisdiction to hear the matter which means that a bankruptcy hearing may be held at a court off the beaten track. There are still problems with issues such as favoritism to local businesses and corruption in PRC courts, in particular in courts outside of the major centres. Therefore, if the debtor is registered outside of the major centres, not only will the judges be very inexperienced but there also may be problems with the overall fairness of the procedure.

Business scope of licensee

Generally in the PRC, companies can only operate under a very narrow business scope and to exceed is considered illegal. It is very rare for a company to be given authorization to engage across the board line of business activities. Therefore it is very important from the onset when your client is contemplating a license agreement, to ensure that the licensee company has the necessary business scope as well as the necessary authorizations to carry out whatever it is being licensed to do. Otherwise, if some problem down the road and licensor tries to sue on the agreement, the agreement may be set aside because local company did not have authority to enter into it in the first place.

For example, distributors of medical devices must have special approval from SFDA and MOFCOM to distribute. Also the medical device to be imported into PRC must be properly registered with the SFDA and the importer must obtain a Medical Devise Registration Certificate. The Registration procedures are very onerous. Another common example is where it is revealed that a Chinese licensee does not have the necessary import / export licenses or authority to distribute the product or technology.

If a licensee went into bankruptcy proceeding, licensor may be precluded from joining in on the proceedings as creditor if the bankruptcy court decides the Chinese party had no authority to enter into such agreement in the first place and deems the agreement null and void.

Register the agreement with the authorities

Generally, all licensing agreements with have to be registered with the proper government authorities. In most cases, it is necessary to register for practical reasons such as obtaining necessary approval from the foreign exchange authority (Ministry of Foreign Affairs, National Trademark Office, State Intellectual Property Office for patents, National Copyright Office) to make payment in foreign currency out of PRC. Also, may be necessary to register such agreement before it will be deemed a binding and enforceable contract under Chinese law. Again, not doing so may result in the licensor being precluded from exercising it legal rights.

Ensure agreement complies with Chinese laws

License agreements must comply with Chinese laws and failure to do so may result in the contact being set aside. Keep in mind this applies even if the parties chose a foreign governing law. For example, Chinese law mandates that ownership of improvements to licensed technology developed by the licensee belong to the licensee, and to place limitations to the contrary in the licensing agreement may result in voiding the contact. Even if contract is governed by foreign law, keep in mind that the agreement still must comply with Chinese laws.

Dispute resolution

China does not recognize foreign court judgments and does not have bilateral agreements with any country to recognize court judgments. Therefore, do not name a foreign court to hear the dispute in the dispute resolution clause.

Generally, advisable to use arbitration with a carve out clause to use the Chinese courts for urgent matters such as contravention of confidentiality, non-compete or theft of IP. China is home to China International Economic Trade Arbitration Commission (CIETAC), which is not too bad but still preferably to use overseas venue if possible. If Chinese licensee does not agree to overseas arbitration venue, good compromise would be Hong Kong or Singapore. Arbitration allows for use of English language and choice of governing language.

Bankruptcy Chinese style

In reality, if a company runs out of money in PRC and it finds itself facing creditors, it is quite common for the owners to disappear in the middle of the night. In fact, the instances of this happening are much more common a company actually applying or being forced by creditors to go through the legal procedures for bankruptcy. When word gets around, suppliers and other creditors could very well show up at the company's gates, hire a team of workers to go in and strip the company of computers, equipment, fixtures and anything of value. Creditors who arrive late are out of luck. Landlords sometimes get into disputes and actual physical altercations with the creditors about who has a right to the assets. Literally, thousands of instances of this nature that have happened in PRC in past year or so. Basically, until now, no one is using the bankruptcy law.

Tips to protect licensor

- Require client's Chinese licensee to pay an upfront license fee at time of signing the license agreement. The bigger the better, even if at expense of lower ongoing payments because there may be great difficulty in obtaining accurate and credible financial sales information from Chinese licensees.

- Require licensees to use ongoing equipment and supplies for example in case of franchise, your computer system, equipment, fixtures, ingredient, food supplies, participate in supply purchase programs, sole supplier of certain equipment (ovens, computer software, POS)
- On other hand, if ask for periodic payment of royalties, then have these be very regular (monthly, maybe even weekly), and keep on top of it if lagging behind. And have form of automatic direct debit for this payment from an account.
- Require a **guarantee** from licensee that can be used in event of non-payment down the road. For example, licensee provides a bank standby letter of credit for duration of the agreement. The standby letter of credit allows for Licensor to make an immediate draw on in event of conditions, such as licensee being unable to remit payment as due the agreement or if becomes insolvent or enters into bankruptcy proceedings. This guarantee would ideally be held in bank outside of PRC. The obligation of licensee to obtain the letter of credit as set forth above is a material obligation and the failure of licensee to obtain and keep in force the letter of credit shall be considered a material breach.
- Include automatic termination clause in event licensee petitions the court or is petitioned by creditors for bankruptcy

Takeaway points

- Undertake proper and complete due diligence to ensure licensor is fully able to carry out the duties and business activities set out under the agreement, otherwise it is possible that pursuant to a bankruptcy proceeding, amongst other proceeding, PRC courts may determine that the licensing agreement is null and void.
- Ensure that license agreement is registered with relevant government authority.
- Be prepared for real possibility that your China licensee would not go through legal proceedings if became insolvent and may just close down without warning.
- Require a large upfront commencement fee.
- Make sure stay on top of payments and take measures immediately on late payments.
- Require a guarantee in form of Standing Letter of Credit that you can draw upon if things go bad.
- DO NOT use foreign courts; depending upon the issue, Peoples' Courts in PRC or arbitration. Typically would use arbitration and carve out use of PRC courts for injunctions or urgent issues.